No. 91-794

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In the
Supreme Court of the United States
October Term, 1992

HENRY HARPER, *et al.*,
Petitioners,

v.

VIRGINIA DEPARTMENT OF TAXATION,
Respondent.

On Writ of Certiorari to the Supreme Court of Virginia

BRIEF *AMICI CURIAE* BY THE STATES OF NORTH CAROLINA AND ARIZONA IN SUPPORT OF THE VIRGINIA DEPARTMENT OF TAXATION

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On Writ of Certiorari to the Supreme Court of Virginia

**Brief *Amici Curiae* by the
States of North Carolina and Arizona
In Support of the Virginia Department of Taxation**

INTEREST OF AMICI CURIAE

North Carolina has a direct interest in the outcome of this case because it has pending before this Court a case raising the same principal question -- the prospectivity or retroactivity of this Court's decision in *Davis v. Michigan Department of Treasury*, 489 U.S. 803 (1989) ("*Davis*"). *Swanson v. North Carolina*, 329 N.C. 576, 407 S.E.2d 791 ("*Swanson I*"), *adhered to on reh'g*, 330 N.C. 390, 410 S.E.2d 490 (1991) ("*Swanson II*"), *pet. for cert. pending*, No. 91-1436. Arizona also has a direct interest because a case raising the same question is presently before the Arizona Court of Appeals. *Bohn v. Waddell*, 164 Ariz. 74, 790 P.2d 772 (Ariz. Tax 1990), *aff'd on reconsideration*, 167 Ariz. 344, 807 P.2d 1 (Ariz. Tax 1991), *appeal pending*, No. 1 CA-

TX 90-029 (Ariz. App.). In these cases, North Carolina and Arizona have estimated potential liability for refunds amounting to approximately one-half billion dollars. Thus, as *amici curiae*, North Carolina and Arizona have compelling interests in the outcome of this case and can illustrate to the Court the profound impact its decision may have on other states and their citizens and taxpayers.

SUMMARY OF ARGUMENT

Virginia, North Carolina, Arizona and other states affected by this Court's decision in *Davis* should not be compelled to pay crippling refunds of pre-*Davis* income taxes. The Court must leave room in the law for consideration of the devastating impact a law-changing decision can have when the Court overrules precedent upon which states have relied or when the Court announces a new rule of law in a case of first impression whose resolution was not clearly foreshadowed.

For many decades before *Davis*, North Carolina, Arizona, and twenty-one other states, without challenge, had exempted the retirement benefits of their retired public servants from income tax to account, in part, for the generally low wages paid to them while working and to encourage public servants to stay in the public's service so that all their citizens could benefit from an experienced public work force. Federal retirees generally received no exemptions or smaller ones. These differences in taxation, though founded on sound, rational public policies, were abandoned following *Davis*, and federal retirees throughout these states thereby effectively received prospective relief. These federal retirees, who had paid taxes on their retirement benefits without challenge for decades, now seek retroactive relief in the form of tax refunds amounting in Virginia, North Carolina and Arizona alone to approximately one

billion dollars. Imposing staggering refund burdens on the affected states -- which had in good faith relied on longstanding, rational and presumptively valid state laws -- would force them to increase the tax burdens on their citizens or cut vital services to citizens at a time when many states are facing grave fiscal crises. The law cannot require such an inequitable result. Equity may in fact be achieved by either of two means.

First, the Court can achieve equity by keeping the prerogative to apply law-changing decisions prospectively when reasonable reliance and the harmful consequences of retroactivity make retroactive application unjust. The analysis prescribed in *Chevron Oil Co. v. Huson*, 404 U.S. 97 (1971) ("*Chevron Oil*"), should be retained to determine whether to apply prospectively a decision which unexpectedly changes the landscape of the law. It provides a logical and rational means by which states' concerns can be addressed by considering the equities of those directly affected by law-changing decisions and allowing prospective-only application of those extraordinary decisions which will have a devastating impact on states which reasonably relied on pre-existing law. Application of the *Chevron Oil* analysis to *Davis* leads inexorably to the conclusion that *Davis* should not be applied retroactively.

The decision in *James B. Beam Distilling Co. v. Georgia*, ___ U.S. ___, 111 S. Ct. 2439 (1991) ("*Beam*"), does not preclude prospective-only application of *Davis*. In *Davis*, Michigan's concession that it would give Mr. Davis a refund if its tax statute was held unconstitutional obviated the need for the Court to consider the retroactivity issue. Thus, principles of *stare decisis* were not implicated. Under *Beam*, a decision ordinarily is presumed to apply retroactively unless the Court indicates otherwise. However, this presumption does not arise

when the issue has been eliminated as part of the case. To apply the presumption and give *stare decisis* effect to a matter that the Court did not even implicitly consider would result in constitutional adjudication through inadvertence or accident. To apply *Davis* retroactively based on Michigan's concession would result in inflicting liability on all states based upon a concession other states would not have made, if given the choice, and which they had no opportunity to influence.

Alternatively, if the *Chevron Oil* analysis is not applied to give *Davis* prospective-only effect, then states should be allowed to refuse refunds of pre-*Davis* taxes as a matter of remedies law. As *Beam* recognized, the states' reliance interests are entitled to consideration in determining the remedy that must be provided for taxes collected pursuant to a statute later held unconstitutional. The Court should make clear that in some cases retroactive decrees, that could seriously undermine the states' financial stability by imposition of unforeseeable after-the-fact liability of mammoth proportions, would be so inequitable that a law-changing decision simply should not be applied retroactively as a matter of remedies law.

This Court should dispel any confusion as to a state's authority -- as either a choice of law or remedial matter -- to deny refunds to federal retirees in the wake of *Davis* by affirming the *Harper* decision.

ARGUMENT

THE STATES SHOULD NOT BE COMPELLED TO PAY REFUNDS OF PRE-*DAVIS* INCOME TAXES TO FEDERAL RETIREES.

Introduction

In 1989, this Court held unconstitutional Michigan's imposition of income tax on the retirement benefits of federal civil service retirees while exempting the retirement benefits of state and local government retirees. *Davis,* 489 U.S. 803. The *Davis* decision unleashed a flood of litigation challenging similar provisions in twenty-three states, including Virginia, North Carolina and Arizona. Now the Court must grapple with the troubling question whether *Davis* requires those states to pay staggering tax refunds to federal retirees. Resolution of this question will have profound consequences for the states affected by *Davis* and for the future.

The potential liability of all the states was initially estimated at $2.2 billion. *See* W. Hellerstein, Preliminary Reflections on *McKesson* and *American Trucking Associations*, 48 Tax Notes No. 3, 325, 326 (July 16, 1990). Virginia's potential liability is now estimated to be $467,000,000.00. North Carolina faces potential liability for refunds estimated in 1989 to be at least $140,000,000.00, exclusive of interest. Arizona's potential liability was estimated to be $261,000,000.00 at the time of the Arizona Tax Court proceedings and is now estimated to be $339,000,000.00 with accruing interest if full refunds are required. However, the Tax Court has ordered refunds using a partial refund formula whereby Arizona's liability would be substantially reduced. Thus, the potential liability of Virginia,

North Carolina, and Arizona alone approaches the staggering sum of a billion dollars.

The Court must consider the devastating impact that refunds to federal retirees would have on the citizens of the affected states. Room must be left in the law for a balancing of equities in those extraordinary situations where, as here, retroactive application of decisions changing the landscape of the law will harshly and unjustly require the redistribution of billions of dollars of the public's money to a relatively few citizens to the detriment of the public as a whole. The Court should uphold the states' denial of retroactive relief to federal retirees based either on choice of law principles or the flexibility inherent in the law of remedies. Whichever theory or doctrinal framework the Court applies, recognition must be given to the inherent inequity to states and their citizens of compelling crippling tax refunds in the aftermath of *Davis* and other decisions which burst upon the horizons of state tax law and upset decades of settled understandings and expectations.

I. THE EQUITABLE INTERESTS OF THE STATES AND THEIR CITIZENS GREATLY OUTWEIGH ANY EQUITABLE CLAIMS OF FEDERAL RETIREES TO *DAVIS* REFUNDS.

The equitable interests of all the citizens of the states engulfed by the *Davis* litigation outweigh the claims of federal retirees for refunds of pre-*Davis* taxes. Years of reliance on rational, presumptively valid statutes, prompt action by states to conform their tax structures to the *Davis* holding, longstanding failure of federal retirees to challenge their tax obligations, and the extreme hardships to states and their citizens which would result from a decision requiring refunds to federal retirees all combine to make refunds harsh and unjust. The extraordinary

harm which would be visited upon the states and their citizens requires that the Court recognize the equitable interests of the states and their citizens as an essential component of its decision in this case. The harsh and unjust consequences of requiring refunds are vividly illustrated by the circumstances in North Carolina and Arizona.

A. State Tax Policies Before *Davis* Stemmed From Rational and Non-Invidious Legislative Choices.

The decision by states many decades ago[1] to exempt fully the retirement benefits of retired state and local government employees had two rational and legitimate purposes: (1) to enhance the benefits of retired employees to offset, in part, the generally low salaries they received while working; and (2) to provide current employees with an incentive to remain in public service and thereby provide all citizens with an experienced work-force to meet their needs. These policies did not "discriminate"

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[1] The North Carolina Local Governmental Employees' Retirement System was created some fifty years ago in 1939 with an income tax exemption for retirement benefits. 1939 N.C. Sess. Laws c. 390, s. 11. The Teachers' and State Employees' Retirement System of North Carolina, created in 1941, also included from its inception an income tax exemption for retiree benefits. 1941 N.C. Sess. Laws c. 25, s. 9. In Arizona, the exemption was in place for thirty-six years. Arizona Code 1939, Supp. 1953, § 12-858; *See also Bohn v. Waddell*, 164 Ariz. at 85, 790 P.2d at 783 (minimum of twenty-five years). Other states' exemptions had also been in place for many years. *See, e.g., Harper v. Virginia Dept. of Taxation*, 241 Va. 232, ___, 401 S.E.2d 868, 871 (1991) ("*Harper I*"), *reaff'd on remand*, 242 Va. 322, 410 S.E.2d 629 (1991) ("*Harper II*") ("almost half a century"); *Bass v. South Carolina*, 302 S.C. 250, 256, 395 S.E.2d 171, 174 (1990) ("*Bass I*"), *reaff'd on remand*, ___ S.C. ___, 414 S.E.2d 110 (1992), *pet. for cert. pending*, No. 91-1697 ("*Bass II*") (since 1945); *Duffy v. Wetzler*, 579 N.Y.S.2d 684, 686, 174 A.D.2d 253, 256 (App. Div. 1992), *app. dismissed*, 79 N.Y.2d 976, 583 N.Y.S.2d 190 (Apr. 7, 1992) (since 1920).

against federal retirees or constitute a "threat" to the federal government in the usual sense of those words. North Carolina exempted $3,000 of the benefits of federal retirees from state income taxes. N.C. Gen. Stat. § 105-141(b)(18) (1973). Arizona exempted $2,500 of federal civil service benefits, 1962 Ariz. Sess. Laws c. 24, s. 43-112(25), but gave no exemption for military retirement benefits. Other than state and local government retirees, federal retirees were the only retirees who received the benefit of an exemption. The federal retiree exemption, like the exemption for state and local retirees, served as an incentive for federal employees to remain in federal service so that all citizens could benefit from experienced federal employees.

Following *Davis*, North Carolina and Arizona repealed the full exemption for the retirement benefits of state and local retirees and adopted a partial exemption for local, state and federal government retirees alike.[2] Now federal retirees, who previously benefited from North Carolina's and Arizona's efforts to secure experienced work forces at both the state and federal level for the benefits of their citizens, seek to have all of the 11 million citizens of these two states suffer an increase in taxes or loss of public services so that federal retirees may receive refunds

[2] North Carolina adopted a $4,000 exemption, and Arizona adopted a $2,500 exemption for local, state and federal government retirees alike. The group who suffered most from this change in the law were the state and local government retirees, who are now required to pay taxes on their benefits despite years of reliance on the full exemption of their benefits from taxation. The value of this lost benefit to retired state and local government employees is estimated to be as much as $50,000,000.00 per year in North Carolina. However, state and local government retirees' challenge to the drastic reduction of their tax exemption was rejected by the North Carolina Supreme Court. *Bailey v. North Carolina*, 330 N.C. 227, 412 S.E.2d 295 (1991), *cert. denied*, ____ U.S. ____, 112 S. Ct. 1942 (1992).

of almost a half billion dollars. The Court's decision in this case may effectively determine whether Virginia, North Carolina, Arizona and other states will be forced to pay out massive sums of money at the direct expense of their other citizens and taxpayers at a time when many states are struggling with severe revenue shortages.[3]

B. Requiring Refunds Would Impose a Crushing Burden on the Affected States and Their Citizens.

During many decades in which state and local retirees paid no income taxes on their retirement benefits, state legislators and executive officials made hard choices year after year about what taxes to impose and in what amounts, about what services to fund and in what amounts, and about how to balance the state revenues and expenses as required by some state constitutions. *E.g.*, Ariz. Const. art. IX § 5; N.C. Const. art. III § 5(3). They necessarily counted on and expended the income taxes paid by federal retirees and all other citizens. All that money has now been spent for the public good, including, for example, the education of the children and grandchildren of federal retirees. None of that money will magically reappear in the states' proverbial deep pockets.

If *Davis* requires refunds to federal retirees, the states must either increase taxes or slash services, or choose some

[3] Of course, states may still have valid procedural or other defenses to federal retirees' refund claims. *See, e.g., Swanson v. North Carolina*, No. 91-1436, Brief in Opposition to Petition for Writ of Certiorari to the Supreme Court of North Carolina, at 18-20.

combination of the two.[4] Higher taxes will be borne by taxpayers who are struggling to cope during these difficult financial times. Working people, private pensioners, and retired people without pensions, who provided for their retirement as best they could through savings and investments, have already paid taxes on their earnings and pensions for past years. Refunds to federal retirees would extract additional taxes from these people, many of whom are less well off than the federal retirees and who paid at least as much tax as the federal retirees. Ironically, even the federal retirees themselves will have to pay greater taxes to fund their pro rata shares of their own refunds.

If the states choose instead to reduce services, the costs of the refunds will be shifted to troubled educational systems, overcrowded correctional systems, children in needy families, and everyone who benefits from the vast array of services provided by state governments, including the federal retirees. Those who are the poorest and the most politically impotent are most in need and, in the imperfect world in which we live, may suffer most. However, no citizen would be immune from the impact. All citizens suffer, and future generations will suffer, when the states' major governmental functions cannot be performed effectively because of insufficient resources, whether through inadequate education, or inadequate attention to the environment, the public health, the labor force, or the criminal justice system.

[4] This Court, and Mr. Harper in his brief, have suggested that in theory the states might limit the specter of monumental refund claims by collecting income taxes retroactively from state and local retirees who previously enjoyed the exemption. The extent to which retroactive taxation is permissible under the Due Process Clause of the Constitution is uncertain, at best. *See McKesson Corp. v. Florida Alcohol and Tobacco Div.*, 496 U.S. 18, 40 n.23 (1990) ("*McKesson*"); *American Trucking Ass'ns, Inc. v. Smith*, 496 U.S. 167, 181 (1990) ("*ATA*"). For North Carolina, an even greater barrier to retroactive taxation is found in the state constitution, which prohibits "laws taxing retrospectively sales, purchases, or other acts previously done. . . ." N.C. Const. art. I § 16. Moreover, retroactively taxing the benefits of innocent retired state and local government employees in order to "cure" the "discrimination" against retired federal employees is hardly a palatable legislative choice.

For North Carolina and Arizona, the stakes are high. Refunding almost a half billion dollars to federal retirees would cripple their ability to meet the needs of their citizens. For example, with regard to North Carolina, $140,000,000.00 is more than the current annual appropriations by the General Assembly to operate both the Department of Labor, which administers the Occupational Safety and Health Act and the state's minimum wages laws, and the Division of Social Services, which administers numerous programs to aid needy, neglected and abused adults and children. It approximates the annual appropriation to the Department of Environment, Health and Natural Resources, which administers all the state's environmental protection programs, and is 70% of the annual appropriation for operation of the state's entire judicial system. 1991 N.C. Sess. Laws c. 689, s. 3. $140,000,000.00 would add approximately 5,000 teachers to the beleaguered public school system. $140,000,000.00 is more than enough money to build at least four new prisons to house over 3,000 additional prisoners, thereby reducing the revolving door phenomenon caused by severe overcrowding. The detrimental effect on the State of North Carolina of paying out that amount of money, totally above and beyond funding its normal operations, cannot be overstated.

For Arizona, the potential refund of $339,000,000.00 is 9.2 percent of the State's Fiscal Year 1993 budget of $3,668,276,400.00. $339,000,000.00 is about one third of the appropriation for the total Health and Welfare services of the state. This amount is roughly equivalent to the $328,715,400.00

projected costs of the Protection and Safety budget for Arizona to be appropriated from the General Fund. $339,000,000.00 is more than half of the appropriation for Arizona's court system and universities combined.

States in which the specter of mammoth *Davis* refunds looms over the budget horizon should not be forced to make such "no-win" choices at a time when they are already juggling severe revenue shortages with their citizenries' most critical needs. *Davis* came at a time when North Carolina was "in dire financial straits," *Swanson I*, 329 N.C. at 583, 407 S.E.2d at 794, and the enormous refund claims by Arizona's federal retirees would "endanger" the state's "financial integrity," *Bohn*, 164 Ariz. at 91, 790 P.2d at 789.[5] North Carolina, in fact, recently faced its most severe budget crisis since the Great Depression. The recession, decreases in federal funding, and other factors combined to create a billion dollar gap between revenues and the needs of citizens. Drastic actions were required. The Governor reduced budgeted appropriations to agencies and imposed hiring freezes. Exec. Order No. 114 (8 May 1990); Exec. Order No. 130 (9 Jan. 1991). The General Assembly enacted the largest tax increase in the state's history. 1991 N.C. Sess. Laws c. 689, ss. 249-338. Despite these actions, many programs and services, such as the State's public university system, continue to suffer from inadequate funding. *See generally* Fiscal Realities for the

[5] This is also the case in other states. In South Carolina, refund of the "exorbitant amount" of $200,000,000.00 "would impose a severe financial burden on the State and its citizens as well as endanger the financial integrity of the State." *Bass I*, 302 S.C. 256, 395 S.E.2d at 174. The $467,000,000.00 sought by Virginia's federal retirees "would come at a time when the Commonwealth is already struggling to meet enormous fiscal deficits" and "would have a potentially disruptive and destructive impact on the Commonwealth's planning, budgeting, and delivery of essential state services." *Harper I*, 401 S.E.2d at 873.

90's: Report of the [North Carolina] Economic Future Study Commission (March 1991); State Treasurer's Annual Report: Fiscal Year 1990/1991; State of the State Address/Biennial Budget Message, 1991 N.C. Sen. J. pp. 1408 *et seq.*

Similarly, Arizona has faced perennial budget crises since the mid-1980's. These crises resulted in the adoption of the 1990 Arizona Individual Income Tax Reform Act. 1990 Ariz. Sess. Laws c. 3 (3rd Special Session). This new law increased income taxes on the average by 17.5% and, through June, 1991, resulted in $123 million of additional revenues.[6] Report Fiscal Services and Analysis Div., Results of the 1990 Arizona Individual Income Tax Reform, Arizona Dept. of Rev., July, 1991.

Crushing financial burdens are undeniably relevant to any judicial determination whether states must make payments or refunds for actions taken under statutes not previously suspected to be unconstitutional. This Court has taken them into account and should continue to do so: "Imposing such unanticipated financial burdens would come at a time when many States and local governments are struggling to meet substantial fiscal deficits." *Arizona Governing Comm. v. Norris*, 463 U.S. 1073, 1106-07 (1983) (Powell, J.). The Court has recognized the inequities of requiring refunds of newly-invalidated taxes which

[6] Because of a decrease in the "age 65 and over" exemption and a higher threshhold for deducting medical expenses, the average increase to age 65 and older citizens was even greater than the overall average increase of 17.5%. Therefore, the Arizona Legislature enacted a minor income tax decrease by increasing this exemption and lowering the medical expense deduction threshhold. 1992 Ariz. Sess. Laws c. 290 (2nd Regular Session); 1992 Ariz. Sess. Laws c. 7 (4th Special Session).

"could deplete the state treasury, thus threatening the State's current operations and future plans." *ATA*, 496 U.S. at 182. Requiring the monumental refunds at issue because of *Davis* "injures all of the [states'] constituents," *id.* at 185, including the federal retirees; state and local government retirees, who relied on long-standing, but now withdrawn, exemptions; and all other taxpayers, working people and retired, who generally had no such exemptions. This Court need not wreak such havoc upon the states and their citizens.

C. Fundamental Fairness Does Not Require the Payment of Refunds to Federal Retirees.

Federal retirees did not pay excessive taxes in comparison to all the other taxpayers in North Carolina and Arizona. Indeed, with the exception of federal military retirees in Arizona, they paid less than their fair share of taxes in relation to all taxpayers except state and local government retirees. The only "injury" they "suffered" was the result of a rational and logical decision of each state to build an experienced workforce of public servants, and to extend to state retirees what appeared simply to be an employment benefit for its own employees, rather than an attempt to discriminate against federal retirees. The federal retirees' "injury," such as it was, resulted not from the denial of an individual constitutional right, but from the violation of a rule designed to protect the federal government from interference with its operations.

For decade after decade, federal retirees paid income taxes on their retirement benefits virtually without challenge.[7]

[7] An equal protection challenge to Arkansas' exemption of state and local retirees was rejected in *Streight v. Ragland*, 280 Ark. 206, 655 S.W.2d 459 (1983). There were no other reported decisions adjudicating direct challenges to such exemptions until *Davis* itself.

Even in states like Virginia and Arizona, where no prepayment of taxes was required, federal retirees did not challenge the constitutionality of such taxation. Hundreds of thousands of federal retirees, who never saw any unconstitutional burden in the taxes they paid until after *Davis* was decided, and who made no efforts to assert constitutional challenges, should not now be allowed to collect a windfall of hundreds of millions of dollars at the expense of all the citizens of their respective states.

The widespread, longstanding and virtually unchallenged existence of state retirees' income tax exemptions cannot be ignored when the Court contemplates the enormous refund claims now facing many of the nation's sovereign states. "The actual existence of a statute, prior to . . . a determination [that the statute is unconstitutional], is an operative fact and may have consequences which cannot justly be ignored. The past cannot always be erased by a new judicial declaration." *Chicot Co. Drainage Dist. v. Baxter State Bank*, 308 U.S. 371, 374 (1940).

Indeed, "absent contrary direction, state officials and those with whom they deal are entitled to rely on a presumptively valid state statute, enacted in good faith and by no means plainly unlawful." *Lemon v. Kurtzman*, 411 U.S. 192, 208-09 (1973) ("*Lemon II*"). In *Lemon II*, the Court rejected the idea that state officials should be required to await adjudication of the constitutionality of newly-enacted state laws or risk having their actions and arrangements unravelled in "draconian, retrospective decrees." *See* 411 U.S. at 207. Here, the federal retirees who have sued the respective states threatened by *Davis*'s progeny should not be able to compel the unravelling of the states' hard budgeting and financial decisions by obtaining draconian

retrospective refund decrees. Those states relied on the presumptive validity not of newly-enacted statutes, but of tax measures adopted and implemented decades before and administered for many years without challenge. *Davis* cannot impose such a harsh penalty on the citizens of the states faced with federal retirees' refund claims.[8]

It is not unfair to the federal retirees to deny them refunds for which they made no constitutional claims and which they had no reason to expect until *Davis* was decided. This is especially true when the stakes are so high and the alternatives so destructive to state budgets and the provision of services to citizens. The Court's constitutional adjudication must leave room for addressing the impact of its decisions when it promulgates unanticipated constitutional rulings. Otherwise, the states' budgets can be wrecked overnight by decisions of which they had no forewarning. The Court can choose among different approaches, two of which are discussed here, to avoid these unjust and destructive results. But, the Court cannot avoid either selecting a jurisprudential theory which addresses these essential

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[8] Contrary to assertions made by the federal retirees, there is nothing abberant about denying them retroactive monetary relief for violation of their rights. Retroactive monetary relief is typically not available against the states and their officials. Principles of sovereign immunity embodied in the Eleventh Amendment, *Pennhurst State School and Hospital v. Halderman*, 465 U.S. 89 (1984), and important principles of public policy embodied in the rule of qualified immunity, *Harlow v. Fitzgerald*, 457 U.S. 800, 819 (1982), often preclude retroactive monetary relief from the states and their officials for violation of federal constitutional or statutory rights. In fact, the Eleventh Amendment and qualified immunity proved a bar to efforts of North Carolina's federal retirees to obtain refunds in federal court. *Swanson v. Powers*, 937 F.2d 965 (4th Cir. 1991), *cert. denied*, ___ U.S. ___, 112 S. Ct. 871 (1992). Qualified immunity also precluded Arizona's federal retirees from obtaining damages from individual taxing officials under 42 U.S.C. § 1983 in *Bohn v. Waddell*, 164 Ariz. at 86, 790 P.2d at 784.

issues or leaving the states and their citizens at the mercy of the vicissitudes of constitutional decisionmaking.

II. *DAVIS v. MICHIGAN DEPARTMENT OF TREASURY* SHOULD BE APPLIED PROSPECTIVELY UNDER A *CHEVRON OIL v. HUSON* ANALYSIS.

This Court has repeatedly held that courts may apply law-changing decisions prospectively when the harmful consequences of retroactivity and reasonable reliance interests make retroactivity unjust. In *Chevron Oil*, 404 U.S. 97, the Court set out a three-pronged test for determining whether a law-changing decision should be applied retroactively or prospectively. *See also, e.g., Florida v. Long*, 487 U.S. 223, 230 (1988); *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 87-88 (1982). The *Chevron Oil* analysis ably facilitates the Court's consideration of exactly the factors which argue against allowing unexpected and unforeseeable decisions to "unfairly surprise" state governments, their financial stability, and their citizens by suddenly imposing devastating after-the-fact liabilities. It provides a logical and rational means by which states' concerns can be addressed by considering the equities of those directly affected by a law-changing opinion and allowing prospective-only application of decisions which will have a devastating impact on those who reasonably relied on the law as it was before the law-changing decision.

The *Chevron Oil* analysis should be retained and applied to the post-*Davis* decisions because it is "settled law" which the Court "should stick to . . . absent some compelling reason to discard it." *Lee v. Weisman*, ___ U.S. ___, 112 S. Ct. 2649, 2668 (1992) (Souter, J., concurring). There is no such compelling reason for discarding it. To the contrary, the *Chevron Oil* analysis "is subject to a kind of reliance that would

lend a special hardship to the consequences of overruling and add inequity to the cost of repudiation." *Planned Parenthood of Southeastern Pennsylvania v. Casey*, ___ U.S. ___, 112 S. Ct. 2791, 2808 (1992). The Court should continue to employ the *Chevron Oil* analysis to determine when a case merits prospective application. The Supreme Courts of Virginia, North Carolina, South Carolina, and Montana, have considered *Davis* to be such a case.[9]

A. *Davis* Was Not Clearly Foreshadowed.

Davis was a case of first impression whose resolution was not clearly foreshadowed.[10] It fundamentally altered the purpose and scope of the doctrine of intergovernmental tax immunity.[11]

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[9] *Harper I*, 241 Va. 232, 401 S.E.2d 868, *reaff'd on remand*, *Harper II*, 242 Va. 322, 410 S.E.2d 629; *Bass I*, 302 S.C. 250, 395 S.E.2d 171, *reaff'd on remand*, *Bass II*, 414 S.E.2d 110; *Swanson I*, 329 N.C. 576, 407 S.E.2d 791, *adhered to on reconsideration*, *Swanson II*, 330 N.C. 390, 410 S.E.2d 490; *Sheehy v. Montana*, 250 Mont. 541, 820 P.2d 1257 (1991), *pet. for cert. pending*, No. 91-1473.

[10] The fact that *Davis* relied on earlier cases as precedent for its holding is no indication that its result was clearly foreshadowed. Hindsight may illuminate a pattern which cannot be identified beforehand. Precedent can be cited to support even the most revolutionary decisions. The Court has recognized that a rule may be a new one even though the Court is able to cite precedent to support it. "Courts frequently view their decisions as being 'controlled' or 'governed' by prior opinions even when aware of reasonable contrary conclusions reached by other courts." *Butler v. McKellar*, 494 U.S. 407, 415 (1990).

[11] Petitioners argue that *Davis* was not a law-changing decision because it did not overrule any earlier decision by this Court. By petitioners' reasoning, if a rule of law has been so generally understood to be correct that no one has ever challenged it (which was actually the case with the pre-*Davis* understanding of the intergovernmental tax immunity doctrine), a decision overturning it by definition would not declare new law and would not be eligible for prospectivity analysis, while a decision finally rejecting a precedent repeatedly assailed and

The purpose of the intergovernmental tax immunity doctrine, prior to *Davis*, was to protect the state and federal governments from undue interference by the other. *Graves v. New York ex rel. O'Keefe*, 306 U.S. 466, 485-86 (1939). Before *Davis*, the states did not expect statutes to be invalidated under the intergovernmental tax immunity doctrine unless they were either aimed at or threatened the operation of the federal government. The immunity served as a political check against the abuse of taxing power when a state imposed a tax on a federal entity. *See United States v. County of Fresno*, 429 U.S. 452 (1977). As Justice Stevens pointed out in his dissent in *Davis*, since the "burden" on federal retirees was shared by many other state citizens, the political check of those citizens' opposition to excessive taxation could legitimately have been viewed as sufficient protection for the federal government from undue interference with its operations through state taxation. 489 U.S. at 820. *See also Washington v. United States*, 460 U.S. 536, 545 (1983). The income tax exemption of state retiree benefits and the taxation of all other retirement benefits is not a tax system aimed at the operation of the federal government or threatening its operation. If the income tax exemptions for state and local government employees had posed a threat to it, surely the federal government itself would have discovered the "threat" and raised the issue itself over the longstanding history of such exemptions. In fact, as compared with its treatment of private pensions, North

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repeatedly upheld only by one-Justice majorities would declare new law and might be eligible for prospectivity analysis. Petitioners' argument is contrary both to logic and to the settled principle – dating back at least to James Madison – that legislators may rely on uninterrupted practice under a statute for the statute's proper interpretation. *See* 4 Letters and Other Writings of James Madison 183-187 (Cong. ed. 1865) (letter discussing the "necessity of regarding a course of practice as . . . a legal rule" or precedent that legislators ought to follow in "interpreting a law").

Carolina's and Arizona's systems benefited federal retirees and thereby enhanced the operation of the federal government by giving all federal employees in North Carolina, and federal civil service employees in Arizona, an incentive to remain in the federal service.

That *Davis* was not clearly foreshadowed by the prevailing understanding of the doctrine of intergovernmental tax immunity or any accepted view of 4 U.S.C. § 111 is illustrated by the discussion in *Swanson v. Powers*, in which the Fourth Circuit Court of Appeals held that North Carolina's Secretary of Revenue was entitled to qualified immunity against the *Swanson* plaintiffs' claims that she violated their rights by enforcing North Carolina's pre-*Davis* income tax laws. The court noted that modern intergovernmental tax immunity cases generally upheld the taxes challenged in those cases and rested on a rationale that "might have suggested a different result in" *Davis*. 937 F.2d at 970. Reviewing various cases that had distinguished between retirees and employees, the court rejected the notion that Secretary Powers could not have reasonably concluded that 4 U.S.C. § 111 applied only to employees, not to retirees. Consequently, "how the intergovernmental tax immunity doctrine and 4 U.S.C. § 111 applied to North Carolina's revenue statutes was anything but clearly established," 937 F.2d at 971, and equally was anything but clearly foreshadowed.

Davis certainly was not clearly foreshadowed in the eyes of federal retirees and their attorneys,[12] or they would not have

[12] Petitioners repeatedly argue that *Davis* must have been predictable because the *Davis* Court itself relied on a "plain language" interpretation of 4 U.S.C. § 111. This argument is circular -- it amounts to the claim that the holding in *Davis* was foreshadowed because the types of argument used in *Davis* were familiar ones. That it is possible to read § 111 in good faith and come to a different interpretation from that of the *Davis* Court is proven beyond cavil by the fact that Justice Stevens vigorously dissented in that case. *See also* the concurring opinion of Justice Stevens, in which Justice Thomas joined, in *Barker v. Kansas*, ___ U.S. ___, 112 S. Ct. 1619 (1992).

waited so long to challenge the state retirees' exemptions under the intergovernmental tax immunity doctrine and 4 U.S.C. § 111.[13] If *Davis* had been clearly foreshadowed by the Court's earlier decisions, twenty-three states would not have exposed themselves to the devastating levels of potential liability currently staring them in the face. Most of the states could have achieved virtually the same result, but without the risk, by repealing the tax exemptions for state retirees' benefits and providing them a corresponding benefit increase.[14] That they did not demonstrates that the result in *Davis* was not clearly foreshadowed in the view of the twenty-three states whose tax structures are implicated by *Davis*. *Davis* thus satisfies the first prong of the *Chevron Oil* test.

[13] Efforts by federal retirees to challenge their income tax treatment through legislative action or complaints outside the judicial system cannot, of course, legally foreshadow the Court's ruling in *Davis* as a matter of intergovernmental tax immunity. *See Swanson v. Powers*, 937 F.2d at 968.

[14] Indeed, the states have generally chosen to comply prospectively with *Davis* by eliminating or reducing the state and local retirees' exemptions. *See*, *Davis v. Michigan Department of Treasury: One Year Later*, Federation of Tax Administrators (1990), pp. 1-2, 12. However, this option may not have been feasible in some states; for example, New York's exemption of state and local government pensions from state income taxes is lodged in the state constitution. N.Y. Const. art. XVI § 5.

B. The Purpose of the Intergovernmental Tax Immunity Doctrine and 4 U.S.C. § 111 Would Not be Served by Retroactive Application of *Davis*.

It is equally clear that the purpose and effect of the intergovernmental tax immunity doctrine and 4 U.S.C. § 111, and consequently of the *Davis* holding, will not be furthered by applying *Davis* retroactively or retarded by applying it prospectively. The states affected by *Davis* have generally responded by prompt adjustment of their tax structures to equalize taxes between federal and state retirees. None of the states had any intent or purpose to harm the federal government or its operations. They had no inkling beforehand that their exemption of state retirees' benefits would be unconstitutional unless coupled with an identical exemption for federal retirees' benefits. Indeed, state retirees' tax exemptions are best characterized as employment benefits for state and local government employees, not primarily as tax measures. Thus, the principal North Carolina and Arizona exemptions were contained in the states' retirement plan statutes, not in their income tax laws. *E.g.*, N.C. Gen. Stat. §§ 128-31; 135-9 (1986); former A.R.S. §§ 38-762(A) and 38-781.22(A). Retroactive liability cannot serve to deter future violations of the intergovernmental tax immunity doctrine or 4 U.S.C. § 111, or encourage future compliance, when the original violation was the product of a reasonable and rational employment benefit when enacted, and the unintentional discrimination was promptly corrected after the Court declared the state exemptions to be unconstitutional.

The tax exemptions for state and local retirees were to all appearances legitimate employment benefits separate and apart from the seemingly wholly legitimate income taxes imposed on all

other citizens, including federal retirees. "[I]t is not the purpose of the [intergovernmental tax immunity doctrine] to prevent legitimate state taxation," *ATA*, 496 U.S. at 181, and the taxation of federal retirees' benefits was legitimate state taxation for decades, insofar as it was possible to discern from judicial precedent or widespread and longstanding practice. Thus, the purposes of *Davis* and of 4 U.S.C. § 111 would not be furthered by retroactive application of *Davis*.

C. It Would Not Be Equitable to Apply *Davis* Retroactively.

Lastly, under *Chevron Oil*, the Court must assess the equities of retroactive application of *Davis*. As argued above, on every scale the equities plainly lie with the states and all their citizens, not with the federal retirees' refund claims. In contrast to Florida's position in *McKesson*, the twenty-three states with tax exemptions for state and local government retirees were undeniably and legitimately surprised by the ruling in *Davis*. *See McKesson*, 496 U.S. at 50. Their legitimate reliance interests are entitled to recognition through a prospective application of *Davis* in view of the utter unforeseeability of its holding in light of past practice and precedent. *See ATA*, 496 U.S. at 182-83. Evaluation of the *Chevron Oil* factors inexorably leads to the conclusion that *Davis* should not be applied retroactively.

D. This Court's Decision in *Beam* Does Not Require a Different Result.

Beam held only that "when the Court has applied a rule of law to the litigants in one case it must do so with respect to all others not barred by procedural requirements or res judicata." 111 S. Ct. at 2448. This rule is based on "principles of equality and *stare decisis*. . . ." *Id.* at 111 S. Ct. 2446. Neither of those

concepts requires retroactive application of *Davis*. *Beam* dealt with the retroactivity of the Court's decision in *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984) ("*Bacchus*"). In *Bacchus*, however, the question of retroactive or prospective application of the Court's holding was argued to the Court. *Beam*, 111 S. Ct. at 2445 n.2. When the Court remanded *Bacchus* for consideration of remedial issues, it had necessarily applied its holding to the *Bacchus* litigants themselves. *Id.* at 2445.

In contrast, the Court did not even implicitly decide whether to apply *Davis* to the litigants in that case because Michigan obviated the need for the Court to address the issue. Michigan cited its own tax refund statute and this Court's decision in *Iowa-Des Moines Bank v. Bennett*, 284 U.S. 239 (1931), for the proposition that Davis was entitled to a refund if the tax structure challenged by him was unconstitutional. Brief for Appellee in *Davis*, p. 63. The Court merely recited and accepted Michigan's concession as the basis for its statement that Davis was entitled to a refund to the extent he had paid discriminatory taxes. *Davis*, 489 U.S. at 817. *Stare decisis* is not implicated here; *Davis* is not precedent for awarding a refund to other federal retirees because the Court never determined the refund issue in *Davis*. *See United States v. L.A. Tucker Truck Lines, Inc.*, 344 U.S. 33 (1952); *United States v. Mitchell*, 271 U.S. 9 (1926). Unlike *Bacchus*, *Davis* cannot be "fairly read to hold as a choice of law that its rule should apply retroactively to the litigants then before the Court." *Beam*, 111 S. Ct. at 2445. Instead, *Davis* can only be fairly read to accept Michigan's concession as an invitation not to address the refund issue at all.

Michigan's refund concession also renders irrelevant the fact that *Davis* did not explicitly reserve the question of retroactivity. *See Beam*, 111 S. Ct. at 2445. Under Justice

Souter's analysis in *Beam*, a decision is ordinarily applied to the litigants in the case before the Court and is therefore presumed to apply retroactively. Because of that presumption, a failure to reserve the question of retroactivity normally indicates that the holding of a particular case must be applied retroactively. However, when the Court is not required, even implicitly, to consider whether its holding in the case before it should apply to the litigants in that case as a matter of federal law, the ordinary presumption is abrogated. There was no need to reserve the issue in *Davis* because, with Michigan's concession, the question simply was not part of the case.

The *Beam* principle of equality among litigants does not support a retroactive application of *Davis*. *Beam's* concern was with the inequity of this Court treating similarly-situated litigants dissimilarly, not with the differences that inevitably result from the several states' varying choices of how to follow this Court's interpretation of federal law. The Constitution sets minimum standards that state remedial schemes must obey; it neither forbids nor requires that states go beyond those requirements. *See McKesson*, 496 U.S. at 52 n.36. Michigan's willingness to grant a refund to Davis himself, for whatever reason, is not the equivalent of a principled decision of constitutional law by this Court, and it should not subject numerous other states to devastating liability.[15] To hold otherwise is to promulgate constitutional law by inadvertence or accident. Because

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[15] Since retroactivity was not an issue in *Davis*, other states had no opportunity to point out the crushing blow which its retroactive application would deal them and their citizens. Nor did those other states, which would not have made the concession Michigan did and whose state laws may be very different from Michigan's statutes, have an opportunity at that time to demonstrate to the Court why *Davis* should not be applied retroactively under this Court's own decisions.

retroactivity was neither litigated nor decided by this Court in *Davis*, *Beam* does not require the retroactive application of *Davis*. This Court should apply the rule of *Chevron Oil* and hold that under federal law *Davis* need only be applied prospectively.

III. THE STATES CAN CONSTITUTIONALLY DENY RETROACTIVE RELIEF AS A MATTER OF REMEDIES LAW.

If the *Chevron Oil* test is not applied to give *Davis* prospective-only effect as a choice of law decision, the Court should allow the states to deny retroactive relief as a matter of remedies law.[16] The authority of the states to do so flows rationally from *Beam's* recognition that remedial considerations may cause courts to deny parties the "relief that would have been awarded if the rule had been an old one." 111 S. Ct. at 2443. If a state demonstrates the kind of legitimate reliance interests given effect through the *Chevron Oil* rule, those legitimate reliance interests are "entitled to consideration in determining the nature of the remedy that must be provided, a matter with which *McKesson* did not deal." *Id.* at 2448.[17]

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[16] "[T]he remedial inquiry is one governed by state law, at least where the case originates in state court." *Beam*, 111 S. Ct. at 2443; *see also* ATA, 496 U.S. at 224 (Stevens, J., dissenting).

[17] *McKesson* established certain minimum due process standards governing state tax refund mechanisms for taxpayers who, without any predeprivation remedy available, paid state taxes involuntarily. However, of critical importance to the result reached in *McKesson* was the Court's explicit rejection of Florida's claim that it relied on a "presumptively valid statute" and its observation that Florida could "hardly claim surprise at the . . . invalidation of" the tax scheme in question. 496 U.S. at 46. *See also ATA*, 496 U.S. at 182 (citing *McKesson* for the proposition that reliance interests are of little concern if the state "can easily foresee the invalidation of its tax statutes. . . .") Thus, in cases in which the law-changing decision was not easily foreseeable, equitable considerations in fashioning a remedy should be given much greater -- or even dispositive -- weight.

The concept that reliance interests may be given effect at the remedial stage is not a new one. Indeed, Justice Souter's opinion in *Beam* drew on the concurring opinion of Justice Harlan in *United States v. Estate of Donnelly*, 397 U.S. 286 (1970):

> To the extent that equitable considerations, for example, "reliance," are relevant, I would take this into account in the determination of what relief is appropriate in any given case. There are, of course, circumstances when a change in the law will jeopardize an edifice which was reasonably constructed on the foundation of prevailing legal doctrine.

Id. at 296 (Harlan, J., concurring). "[F]lexibility in the law of remedies," *id.* at 197, permits courts to refuse to award retroactive relief when its consequences are unduly harsh and disturb settled and justifiable expectations.

This Court has not always clearly articulated whether a particular decision was applied prospectively only as a matter of remedies law or otherwise. *E.g.*, *Buckley v. Valeo*, 424 U.S. 1, 142-43 (1976); *Cipriano v. City of Houma*, 395 U.S. 701 (1969). However, it has repeatedly affirmed that some decisions would simply be too disruptive and work too great a hardship on innocent parties to be applied retroactively. Thus, the potentially "devastating" impact on pension funds of retroactive liability led the Court to deny retroactive relief under Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000e, when it held that a pension fund's monthly contribution levels unlawfully discriminated on the basis of sex. *Los Angeles Dept. of Water &*

Power v. Manhart, 435 U.S. 702 (1978).[18] In *Lemon II*, the Court cited *Chevron Oil*, but it also treated the prospectivity/retroactivity question as one of equitable remedies. 411 U.S. at 197-200. The Court chose to "look to the practical realities and necessities inescapably involved in reconciling competing interests, notwithstanding that those interests have constitutional roots." *Id.* at 201. Good faith and reliance on a statute, which the state could not be expected to predict would be invalidated, justify prospective application; otherwise, states would have to "stay their hands" until statutes are at some point "ratified" by this Court's decisions or "risk draconian, retrospective decrees," a prospect which "could seriously undermine the initiative of state legislators and executive officials alike." *Id.* at 207-08. There are times when the Court has simply acknowledged that "[t]here is no justification . . . to impose this magnitude of burden retroactively on the public." *Arizona Governing Comm. v. Norris*, 463 U.S. at 1107 (1983). This is such a case.

If *Davis* is to be applied retroactively as a choice of law, then state courts must be able to deny retroactive relief on an equitable basis at the remedial stage in appropriate tax refund cases arising in state courts just as this Court has done in appropriate constitutional and statutory cases arising in federal courts. That is exactly what Virginia has done in this case. Its decision should be affirmed. Extraordinary liability of the magnitude faced by Virginia ($467,000,000.00), North Carolina (at least $140,000,000.00, exclusive of interest), Arizona ($339,000,000.00) and other states should not be imposed on

[18] The *Manhart* decision was reached in the face of a strong Title VII "presumption in favor of retroactive liability [which] can seldom be overcome." 435 U.S. at 719.

unsuspecting states as the result of an unforeseen and unpredictable decision invalidating statutes which had existed virtually unchallenged for up to fifty years. Equity cannot permit federal retiree taxpayers to reap such an unanticipated and unjustifiable windfall at the expense of all the citizens and taxpayers of their respective states.

CONCLUSION

The question before this Court boils down to the propriety of imposing enormous and unforeseen liabilities on the states as a result of *Davis*. Should the citizens and taxpayers in all these states be forced to shoulder additional tax burdens or suffer significant reductions in services because of the states' failure to extend to federal retirees an exemption granted to state and local governmental retirees as a form of employment benefit? Should federal retirees be allowed to recover hundreds of millions of dollars in refunds of taxes they paid year after year after year without challenge? To ask the question is to answer it. The Court should apply *Chevron Oil* to hold that *Davis* is to be applied prospectively only or should allow refunds to be denied as a remedial determination that retroactive relief is not appropriate.

The Court should affirm the decision of the Virginia Supreme Court and the decision of the other state supreme courts denying refunds to federal retirees for pre-*Davis* taxes, which are currently pending before the Court, including the decision of the North Carolina Supreme Court in *Swanson v. North Carolina*.

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